



## 11 o'clock files

# Simply the Circular Flow of Income

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- The circular flow illustrates the interrelationships between households, firms, the government and the foreign sector.
- It focuses on the flow of expenditures on domestic output and the flow of incomes generated in the production process.
- We assume that households own all resources<sup>1</sup> → these are offered to firms in return for factor payments<sup>2</sup> → their sum is defined as *national income*
- Firms use the resources to produce goods/ services which they sell to households → households thus make expenditures on goods and services

### Now add a banking sector, the government and a foreign sector:

- Part of the income generated each period may not be spent as it may be saved<sup>3</sup> → *1st leakage*
- But, it is not only households that spend on domestic output → firms spend when they buy capital goods → investment<sup>4</sup> expenditures → *1st injection*

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<sup>1</sup> anything used in the production process: Land, Labor, Capital and Entrepreneurship

<sup>2</sup> rents, wages, interest payments and profits

<sup>3</sup> savings: income not spent

<sup>4</sup> investment: spending by firms on capital goods

- Since we assume a government, part of national income cannot be spent or saved as it must be paid in taxes → *2nd leakage*
- But the Government also spends on domestic output when it builds roads and schools → *2nd injection*
- Lastly, if this is an 'open economy' (one with international trade) part of national income may not be spent on *domestic* output, saved or used to pay taxes → it may be spent but on foreign goods i.e. on imports → *3rd leakage*
- But spending on domestic output may originate from foreigners → these expenditures are 'our' exports → *3rd injection*
- National income (NY) will be in equilibrium if Withdrawals (W) = Injections (J)

**The rest is a cinch:**

- If any J decreases and/or any W increases → NY↓
- If any J increases and/or any W decreases then NY↑